



**Review into the Governance, Efficiency, Structure and
Operation of Australia's Superannuation System**

ACTU submission on Structure

26 February 2010

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Introduction

The review panel's papers on super structure and relating governance to choice raise a number of important issues for the superannuation industry in Australia and the millions of workers who depend on it to help deliver an adequate retirement income.

This submission focuses on those issues of particular concern to the ACTU and our affiliates. It should be considered alongside our previous submissions to the panel.

We would welcome the opportunity to meet with members of the panel to elaborate further on this submission.

The Choice Architecture Model

The review panel paper *Clearer Super Choices: Matching Governance Solutions* outlines a 'choice architecture model' that seeks to align fund members to an appropriate mix of governance, investment, insurance and disclosure arrangements based on the degree of choice they wish to exercise in relation to their superannuation. In short, the more choice members make, the more responsible they will be for the risks and costs that those choices entail.

The ACTU welcomes the panel's recognition that member disengagement is, and is likely to remain, a key structural feature of our superannuation system. Instead of attempting to recast fund members as perfectly informed rational actors, public policy should instead engage with the complex social realities of member inertia, bounded rationality, unstable preferences and limited financial literacy.

We have argued in our previous submissions to the review that disengaged members have distinct interests that government, regulators and trustees have a special responsibility to protect and promote. In the absence of levels of engagement and financial literacy conducive to informed choice there should be mechanisms for ensuring such members are allocated to funds that do not exist to make profits for others and which serve members by charging relatively low costs and delivering strong performance.

These mechanisms and funds already exist.

We discuss the role of the industrial relations system in allocating members to default funds later in this paper.

Existing industry funds operate with a trustee-centric governance philosophy. They offer default investment strategies with asset allocations and related risk profiles appropriate to disengaged members. They offer default insurance packages comprising death and TPD insurance. Reporting and disclosure to default members is already limited and industry funds will welcome regulatory change that facilitates further appropriate streamlining. Finally, and related to these fund features, industry funds consistently charge less to members and perform better than retail funds.

Given the governance, structure and performance of existing industry funds, and their leading role as recipients of disengaged members, it is not clear to the ACTU why the

review panel feels there is a need for a significant departure from existing arrangements. If there is a compelling case for such change the panel's paper does not make it.

This does not mean existing arrangements are ideal in every respect. The ACTU believes there is a need to refine aspects of the current system, particularly in relation to which funds should be eligible for nomination as defaults within modern awards. We discuss this issue in more detail below. There is also scope for extending the role of industry funds. Because the industry fund model has proven to be highly effective in defending and promoting the interests of the disengaged we have argued in previous submissions that all such employees, not just those formally covered by an award, should be allocated to an appropriate industry fund.

In relation to disengaged members in particular we believe the panel has not established why existing arrangements are sufficiently flawed so as to require significant regulatory change.

We are also concerned that the panel does not appear to have given sufficient thought to the problems involved in implementing the new model. For example, for the purposes of initially allocating fund members between Universal and Choice categories it is not clear how the model would distinguish between those who are members of a default fund with the default investment strategy because they have made no choice, and those who are members of such a fund and default strategy because they have chosen to be so.

There is also a risk that the new model may increase costs to members and so impact negatively on their long-term retirement income. For example, some funds may not be able to realise sufficient economies of scale to fully absorb the additional costs of establishing and operating discrete member categories each with distinct products, services and obligations to members. Nor is it clear that mandating life-cycle investment strategies for Universal members is necessarily consistent with low costs.

The panel's paper is also unclear on the question of how exercising choice would lead to members being re-categorised. The paper states that in the Universal category the ability to change option/fund would be 'less frequent' than under Choice. It is unclear why a Universal member who, after a period of disengagement, makes a significant choice about their super arrangements should potentially remain in the Universal category. It is also unclear how, when and under what circumstances a Choice member who has become disengaged would be allocated to the Universal category.

Given the limited costs that could be legitimately charged to Universal members, we can foresee potential conflicts of interests between for-profit funds and members as regulatory ambiguities combine with partial financial advice to generate opportunities and incentives to move members out of the Universal category into higher cost categories and to avoid moving newly disengaged members into lower cost categories.

More generally, it is not apparent from the panel's paper that they have given any thought to the potential conflicts of interests that their proposals, if implemented, may generate or perpetuate and how they should be managed. Any recommendation to implement the model that does not include a detailed assessment of such potential conflicts would lack credibility.

Finally, we note that the panel has not discussed the potential implications of the choice model for public sector funds. Should the government decide that changes to arrangements in the public sector are warranted in light of any changes outside the public sector then our public sector union affiliates will wish to negotiate any proposed changes with the relevant heads of government.

In summary, the view of the ACTU is that the case for the new choice model has not been made. Present arrangements, particularly as they apply to disengaged members, operate well and should be refined rather than replaced. We would urge the panel to focus on those suggested refinements which are discussed below and in our previous submissions.

Awards and Default Funds

The Issues Paper asks if the industrial relations mechanism is the best way to allocate employees to a default superannuation fund.

The ACTU strongly supports the present system of allocation. It has proven to be an effective, fair and flexible means of serving the interests of the many employees who do not make an active choice about which super fund to join.

Present arrangements offer a number of important advantages.

Firstly, they relieve employers of the responsibilities and costs involved in choosing a default fund. Research shows that most employers strongly support the inclusion of default funds in awards¹. In part this is because many employers regard their super obligations as a burden to be minimised. This is why, as the Issues Paper notes, many of those not formally covered by an award are content to simply adopt the default fund that already applies across much of their sector.

We note that the main employer associations have also expressed their continued support for present default arrangements.

Secondly, they offer flexibility. It remains open to individual employees to leave the default fund at any time and join another fund of their choice. It also remains open to every employer and their employees to reach an enterprise agreement that specifies a default different from that specified in the relevant award.

Furthermore, all super funds are free at all times to market their products to specific employers and groups of employees with the aim of convincing them that it is in their interests to reach a new agreement that specifies their fund as the default.

The award-default system offers flexibility in another respect. All modern awards will be subject to periodic review by Fair Work Australia. There will be an opportunity for employers and employees to formally review default arrangements and change them if they wish.

¹ Industry Super Network (2009) *Super System Review Phase 2 Operation and Efficiency: Appendix 2 Employers and Workplace Default Superannuation Funds*.

Finally, they best serve the interests of employees who do not make an active choice. The large majority of defaults nominated in awards are industry funds. In most cases this is because the relevant employers and unions have agreed that it should be an industry fund which is nominated.

In previous submissions to the review the ACTU has reported the cost and performance advantages of industry funds compared to those in the retail sector. We do not intend to repeat that detail here. However, we note the APRA data released on 10 February 2010 which shows yet again that industry funds continue to outperform retail funds².

While the industry fund sector has performed well on average the ACTU is not indifferent to the potential for particular funds within the sector to underperform. We believe that only those funds that meet certain criteria should be eligible for nomination as a default in an award. In our submission to phase two of the review we specified a number of appropriate selection criteria³.

To this list we would add that only those funds which have a recent record of low costs and good performance comparable to the average for industry funds should be eligible for nomination.

Unions recognise that having many different industry funds does not offer more choice of investment options to employees. However, they definitely contribute to higher investment and administration costs. Unions are therefore taking responsible action by being actively engaged in facilitating industry fund consolidation.

Retail funds continue to argue for new arrangements based on ‘employer choice’ in the hope that this will give them easier access to large numbers of passive contributors many of whom have little or no understanding of complex financial products. They understand that passivity, inertia and limited financial literacy offer ample opportunities to impose high charges and fees at the expense of member interests. We trust the review panel understands this too and will therefore reject such proposals.

The ACTU recommends that:

- The current industrial relations mechanism for allocating employees to a default fund continues in its present form.
- Only those funds that meet certain governance, cost and performance criteria should be eligible for nomination as a default.

Super in Post-Retirement Phase

The issues paper asks what can be done to improve the availability of retirement income stream products in the Australian market.

² APRA (2010) *Annual Superannuation Bulletin June 2009*.

³ See para 12 in ACTU (2009) *Review into the Governance, Efficiency, Structure and Operation of Australia’s Superannuation System: ACTU submission on Operation and Efficiency*.

The market for lifetime annuities in Australia is under-developed. For a range of reasons⁴ the private sector in Australia offers limited opportunities for individuals to use their accumulated savings to independently cover themselves against the inflation, investment and longevity risks inherent in retirement.

An important consequence of the very low take-up of lifetime annuities can be a too-rapid depletion of retirement savings.

We believe the government should consider providing a lifetime annuity product to help fill the space left by the private sector by selling increases in the public pension⁵. Retirees would pay a lump sum to the government in return for a pension indexed to wage growth and determined on an actuarially fair basis. Centrelink would administer the pension while fund management could be conducted by a government agency such as the Future Fund. Both organisations and their staff would need to have adequate additional resources and training to perform these roles effectively.

This form of annuity product would benefit from the government's greater capacity to invest assets in a risky portfolio against long-term liabilities of this kind, the government's status as a very low default risk, and its related capacity to access capital at relatively low costs.

The costs and broader market impacts of such a product would need to be carefully modelled and assessed. However, initial modelling by Access Economics for ISN/AIST suggests that the scheme could have a significant positive impact on aggregate retirement income, particularly via boosting the incomes of those who live beyond average life expectancy and who may be more likely to have run down their retirement savings.

The ACTU recommends that:

- The government offer lifetime annuities utilising the administrative structure of the public pension, the government actuary and possibly the investment expertise of the Future Fund.

Collective Pension Schemes

Referring to the example of pension arrangements in the Netherlands the paper asks if there is room in the Australian system for a model of collective pension provision.

The Dutch second pillar covers approximately 90 per cent of the labour force and is commonly referred to as comprising 'hybrid DB-DC funds'. In a traditional DB plan accrued liabilities are fully indexed for wage growth with changes to the contribution rate used to absorb a funding surplus or shortfall. In a DC plan the contribution rate is fixed and only the indexation rate is adjusted according to the financial position of the fund.

In the Dutch hybrid schemes fund managers can adjust both the indexation rate and contribution rate simultaneously to absorb a surplus or shortfall in pursuit of a declared

⁴ Knox, D. (2000) *The Australian Annuity Market*. World Bank, Washington.

⁵ This recommendation was originally made by ISN and AIST in their submission to Australia's Future Tax System Inquiry on the retirement income system in February 2009.

aspiration to pay a full-career pension benefit of 70 per cent of the average wage (inclusive of any entitlement to the first pillar public pension).

Relative to the Australian system the Dutch second pillar has a number of positive features. Firstly, it combines an explicit aspiration to pay a benefit of a given proportion of the average wage with flexible funding tools that increase the likelihood that such an aspiration will be achieved. Secondly, risk is shared between generations.

As the panel has noted, compared to many other OECD countries Australian fund members bear a high level of risk as individuals. This is a weakness of our present system which may have significant negative implications for many Australian workers if the future proves to be significantly more volatile and uncertain than is widely assumed.

The ACTU therefore believes that examples of collective risk sharing, such as the Dutch second pillar, and their potential applicability to Australia deserve further research and consideration by government. Because a collective model would mark a significant departure from present arrangements further action on this issue should not be contingent on the extent of support expressed by established super system participants at the present time.

The ACTU recommends that:

- The review panel recommend to government that it takes appropriate steps to research this issue further and consider how and to what extent an appropriate collective model may be able to deliver greater certainty and security for workers in an Australian context.

Participation

Over the past 25 years a large and complex superannuation system has emerged in Australia which, while representing a significant advance over previous arrangements for many workers, continues to exclude and poorly serve too many members of our community.

The ACTU Congress in 2009 adopted a detailed policy on superannuation and retirement income that included calls for specific measures to help tackle some of the barriers to full and effective participation in the superannuation system experienced by significant sections of our society – women and Aboriginal and Torres Strait Islanders in particular.

Women

In relation to women the review panel have stated that they do not want comments on the issue of adequacy resulting from broken workforce participation and lower average incomes because this falls within the scope of the Henry tax review. However, there are a number of other important issues relating to the participation of women that the panel should consider.

Firstly, the \$450 threshold for the superannuation guarantee should be removed. This threshold disproportionately impacts on women who often combine caring and other

household-related responsibilities with low-paid part-time employment. It also acts to exclude those, especially women, who hold a number of separate low-paid part-time jobs which can approximate to a single full-time job in terms of total hours and income, but because payment from each employer does not meet the SG threshold the employee is excluded from the super system.

Secondly, long-term carers in receipt of Carer Payments or Allowances should have additional superannuation payments made by the government on their behalf. Women are disproportionately responsible for caring for ill and disabled children and other family members on a long-term basis. Many long-term carers are unable to participate in the labour force because they play a vitally important social role in providing essential support to some of the most vulnerable people in our society. They should not be penalised for doing so by being denied the chance of a decent standard of living in retirement.

Thirdly, the broken and marginal participation in the labour force experienced by many women is likely to reinforce already low levels of financial literacy. Government and funds have a special responsibility to address the particular literacy needs of such women. Government and funds should fund and co-ordinate additional literacy programs that address the particular needs of women, particularly the young and those in Indigenous communities, whose limited labour market participation is likely to act as a barrier to a better understanding on how they can plan more effectively for their eventual retirement.

Finally, the government should include superannuation in the paid parental leave scheme. We note that the Productivity Commission has recommended such an inclusion. Failing this the government should make a one-off payment to the nominated superannuation account of each new mother that is equal to the net Superannuation Guarantee contributions that would be payable on the maternity leave income payments.

Aboriginal and Torres Strait Islanders

Our superannuation system is not suited to the needs of many Aboriginal and Torres Strait Islanders. It assumes all individuals possess what are actually culturally-specific language, literacy and numeracy skills. It assumes all individuals live in economic, familial and cultural circumstances supportive of particular financial behaviours and outcomes. These assumptions act to exclude and disadvantage many Indigenous Australians.

There are a number of practical measures government and the super industry can take that would help to tackle this structural disadvantage.

Firstly, in recognition of the gap in average life expectancies between Indigenous and non-Indigenous communities, early access should be allowed to preserved superannuation accounts, retirement and aged pensions.

Secondly, training and education should prepare trustees to pay greater attention to the particular nature and needs of Indigenous Australians. In particular, when releasing the funds of a deceased Indigenous member trustees should be encouraged to pay appropriate regard to the diversity of Indigenous family and dependency arrangements and the specific nature of their kinship structures. Trustees should also be made more aware of the difficulties in accessing formal identity and financial documentation faced by some family members and dependents, particularly those in remote locations.

Thirdly, participants in Community Development Employment Projects (CDEP), either as wage earners or income support recipients, do not meet the definitions of an employee under present superannuation legislation. Nor are CDEP organisations defined as employers for superannuation purposes. As a result participants not covered by the Superannuation Guarantee. We recommend that payments made to CDEP participants should be included as wages for the purposes of the 1992 Act.

Insurance

The distribution of insurance via the super system in a context of significant underinsurance has proven to be efficient and effective. Industry funds in particular have shown it is possible to provide affordable insurance cover to specific groups at premium rates well below those charged by retail funds⁶. The problem of underinsurance has been compounded by retail profiteering which acts as a significant drain on our super system. We hope the review panel intends to recommend measures in its final report that will help to alleviate this drain.

The insurance offered by industry funds is low cost, distributed effectively to many workers who may potentially benefit most from having it, and can be tailored to specific needs and circumstances if requested. This is achieved without industry fund members, most of whom are members by default, having to pay commissions. The Issues Paper asks if commissions should be payable on default fund life insurance. The answer in principle is no. The answer in practice is that the industry funds have shown there is no need for such commissions. They should therefore be prohibited.

The Issues Paper asks if the minimum cover required in a default fund should be more closely tailored to specific family and financial circumstances. Given the nature of default fund members, and the quality and quantity of reliable data that funds hold about most of their default members, it is unlikely that further specification is possible beyond age and broad occupational group.

The Issues Paper asks to what extent income protection insurance relating to illness or injury short of total and permanent disablement should be embedded in superannuation. Our view is that this should be a matter for trustees to decide given the particular nature of their membership and the capacity of those members to be insured by other means. Income protection can be offered by funds on an opt-in or opt-out basis. For some groups of low-paid workers in manual jobs the cost of private insurance is prohibitively high and provision via a default scheme offers the only affordable option. For others income protection will fill gaps in work cover and transport accident schemes.

However, we also think there may be a role for parts of our super system in providing income protection insurance relating to involuntary unemployment.

In context of the global financial crisis the ACTU has been considering how a 'flexicurity' model of income protection could be developed in an Australian context. A research report containing recommendations has been produced for our Executive. The

⁶ The submission to the review panel on 'Structure' from Industry Super Network contains figures in support of this assertion.

Federal government has a copy and the issues it raises are currently being considered. A copy of the report is included with this submission.

The report argues that, in the medium to long term, a comprehensive unemployment insurance scheme operated through or in conjunction with Australian industry funds is economically feasible and sustainable. The scheme would involve 1 per cent of a future increase in the SGC to 12 per cent being separated and committed to unemployment income insurance cover on an opt-out basis.

We refer you to the report for a more detailed discussion of the scheme design.

In sum, the ACTU recommends that:

- Measures are taken to tackle profiteering by retail funds in the provision of insurance. These should include banning commissions.
- It should be a matter for trustees to decide whether to offer income protection insurance relating to illness short of total and permanent disablement.